On Our Radar – April 2024

In the first quarter of 2024, the financial markets witnessed a mixed landscape: stocks and commodities achieved milestones, while long-term U.S. Treasury bonds dipped as interest rates ticked higher. Notably, the Dow Jones Industrial Average, S&P 500, and NASDAQ Composite all recorded record highs by late March. Concurrently, the yield on 10-year U.S. Treasury bonds escalated from 3.88 percent at year-end to 4.32 percent on the first of April.

The commodities market also displayed impressive trends. Gold's value reached a historic peak, trading above $2250 per ounce. Similarly, West Texas Intermediate crude oil prices climbed to over $83 per barrel, up from around $71 at year-end. Furthermore, cocoa futures witnessed a significant surge, soaring beyond $10,000 a ton, marking an increase of over 130 percent this year, indicating a forthcoming rise in chocolate prices.

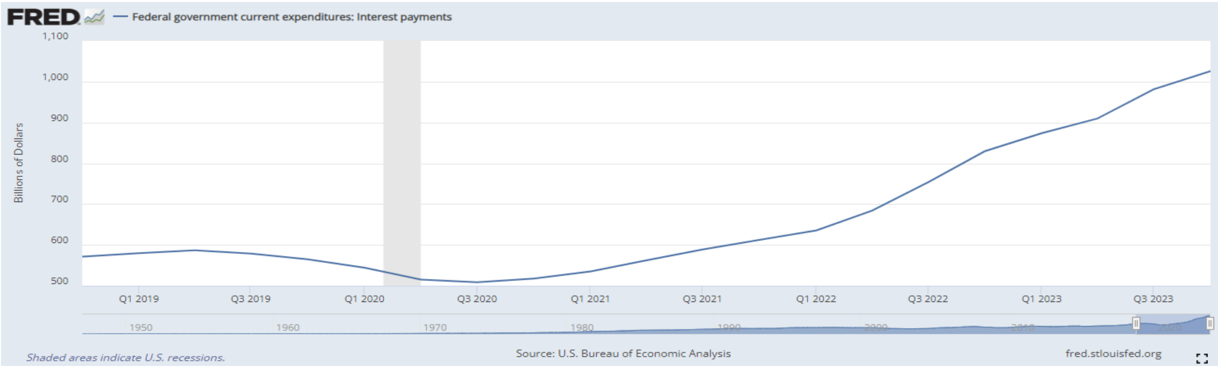
TJT Capital Group's InVEST Risk Model ® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

In its March Summary of Economic Projections, the Federal Open Market Committee (FOMC) revised its outlook for the U.S. economy in 2024, projecting a robust Gross Domestic Product (GDP) growth rate of 2.1 percent, a notable increase from the previously estimated 1.4 percent in December. Additionally, core inflation is anticipated to edge up to 2.6 percent, slightly above the earlier forecast of 2.4 percent. Despite these adjustments, the Fed is anticipated to lower interest rates three times in 2024.

The Fed also predicts an uptick in the U.S. unemployment rate to 4.0 percent in 2024, from 3.4 percent in May 2023. This projection is curious given the historical trend that a 0.6 percent rise in unemployment has always preceded a recession.

However, the relationship between many economic indicators has been completely distorted due to the COVID response measures as it seems as if Washington, D.C. has normalized crisis-level spending. As such, annual interest payments on U.S. federal debt now exceeds $1 trillion a year, roughly double the amount in 2020, and projections suggest that these payments could exceed $1.6 trillion by year-end.



Economist Milton Friedman famously remarked that "there's nothing so permanent as a temporary government program," highlighting the tendency of short-term measures to become fixtures.

Reflecting this sentiment, the Biden administration's 2025 budget proposal outlines $7.3 trillion in spending, accompanied by an anticipated budget deficit of $1.8 trillion. This follows the Congressional Budget Office's forecast that the nation will run a $1.6 trillion deficit in fiscal 2024 ending in October.

Valuation

As we anticipate the final figures for the S&P 500 companies' earnings in 2023, estimates suggest them to be approximately $213.50, marking an 8.4 percent increase from calendar year 2022. Looking ahead, the earnings forecast for 2024 stands at around $240, indicating a further increase of 12.4 percent.

Reflecting on the estimated earnings for 2024, the S&P 500 currently represents a Price/Earnings (P/E) ratio of roughly 21.8. This means that the index is trading at 21.8 times its earnings. Given the rising interest rates since the beginning of the year, we view the valuation of the S&P 500 to be in neutral territory.

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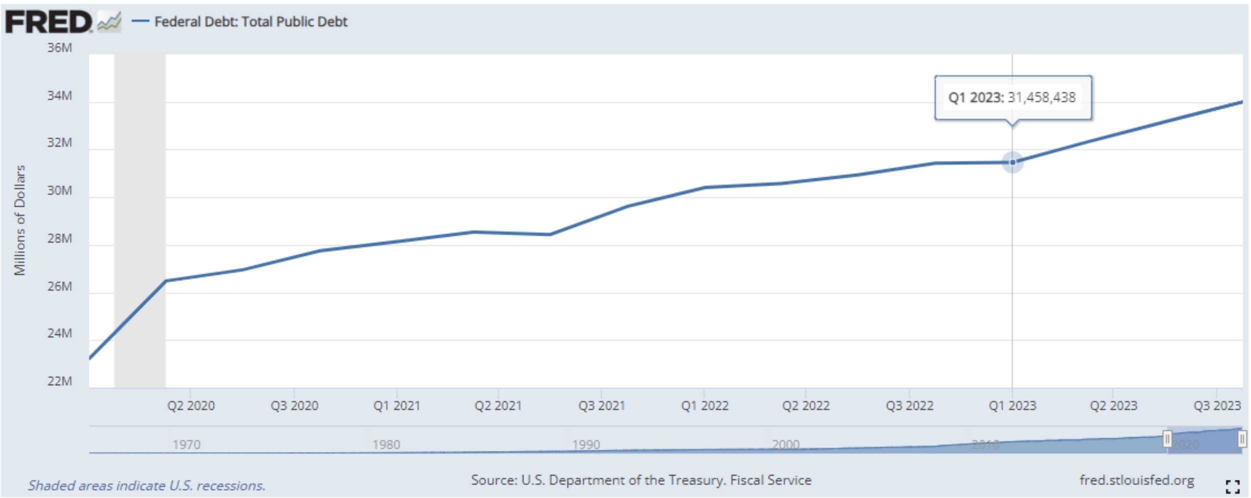
Economic Cycle

On the economic front, the U.S. economy grew at a revised 3.4 percent in the fourth quarter while the Fed's preferred inflation gauge – Core Personal Consumption Expenditures (Core PCE) rose 2.8 percent on a year-over-year basis. The manufacturing sector showed signs of improvement as the Institute for Supply Management (ISM) Manufacturing Index increased to 50.3 in March, indicating expansion for the first time since September 2022, along with an uptick in production costs.

The Leading Economic Index (LEI) increased by 0.1 percent last month, U.S. Consumer Sentiment increased to 79.4 in March, up from 76.9 in February, and U.S. existing home sales rose 9.5 percent month over month as mortgage rates eased.

However, this economic resiliency is heavily underwritten by deficit spending. By the end of February, the U.S. debt had ballooned to approximately $34.4 trillion, marking a staggering $3 trillion increase from the first quarter of 2023 as seen in the chart below. This trend suggests an alarming rate of debt accumulation, averaging a trillion-dollar increase every 120 days.



Sentiment

We view investor sentiment as a contrarian indicator, particularly when it reaches extreme levels. The stock market's rally since late October has been accompanied by a significant shift in bullish sentiment, climbing from just over 40 percent to more than 60 percent. Additionally, the Bull minus Bear ratio has escalated to the mid-40s range, a figure that is considered quite elevated by historical standards.

To illustrate, during the market's peak in October 2007, the Bull minus Bear spread reached 42.4 percentage points. Although this indicator alone doesn't predict an imminent market downturn, it suggests that any disappointing news or unfavorable developments could exert pressure on the market.

Technical Factors

Recently, the percentage of stocks trading above their 50-day moving averages decreased to approximately 56 percent, a decline from a high of over 80 percent at the year's end. Conversely, the quantity of stocks reaching new 52-week highs has, for the most part, shown a steady increase since the end of the year, while the number of stocks hitting new 52-week lows has stayed relatively low.

However, these trends may shift if interest rates continue to rise or if there's a change in the Federal Reserve's stance on interest rate cuts.

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Outlook

The Federal Reserve has become a primary source of uncertainty in the bond market, despite its assertions of being data-driven. It has projected at least three interest rate cuts, aiming to offer "forward guidance." Yet, this guidance has frequently led to confusion, with the Fed's strategies over recent years receiving criticism for their inaccuracy.

A significant misstep by the Fed was to conclude that inflation was too low, and that the U.S. needed an inflation makeup strategy, which Powell began talking about publicly as far back as March 2019. This approach, was based on the belief in the necessity of an inflation "overshoot" without preemptive rate increases. From Milton Friedman's perspective, "inflation is a policy," which underscores the intentional nature of this strategy, which seems radical, especially considering inflation reached a 40-year high before the Fed opted to increase rates.

The Fed's confidence in using monetary policy as a tool to finely adjust inflation to a 2 percent average appears overly optimistic, particularly given the eventual surge in inflation rates. This discrepancy highlights the gap between theoretical economic models and real-world outcomes. Indeed, Fed Governor Waller's admission that the Fed had "bet the farm" on low inflation, only to be proven incorrect, suggests a significant oversight in their predictive models.

Nevertheless, Jerome Powell told Congress that rate cuts “can and will begin” this year, signaling a shift towards stimulating economic growth and perhaps a lesser focus on inflation, possibly due to concerns over rising debt levels. With higher debt, economic growth becomes crucial to manage increasing interest expenses.

In summary, with the economy expanding, corporate earnings forecasted to improve, and the Federal Reserve indicating upcoming interest rate reductions, the outlook for equity markets is positive. However, geopolitical tensions pose a risk of increased volatility, which may, in turn, offer opportunities for increasing exposure. (4.2.24)

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